



**UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR
THE PREPARATION OF A DRAFT CONVENTION ON
HARMONISED SUBSTANTIVE RULES REGARDING
SECURITIES HELD WITH AN INTERMEDIARY**

Rome, April 2005

UNIDROIT 2005
Study LXXVIII – Doc. 20
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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

*(Comments by the Government of Finland, the Government of Spain, the International Swaps
and Derivatives Association, Inc. (ISDA) and by the European Banking Federation)*

MINISTRY OF JUSTICE
Finland
Law Drafting Department

1 April 2005

OM 3/86/2005

The International Institute for the Unification
of Private Law (Unidroit)
Via Panisperna 28
00184 Roma
Italia

Dear Sir,

With reference to the note verbale of 23 December 2004 the Government of Finland would like to thank for the possibility to comment the preliminary draft Convention on Harmonised Substantive Rules regarding securities Held with an Intermediary (later Convention) and bring our main concern to your attention.

According to the explanatory notes the purpose of the future instrument is to promote legal certainty and economic efficiency with respect to cross-border holding and disposition of securities held with an intermediary. The harmonisation of the key elements is required not merely to promote internal soundness within the domestic legal framework but above all to promote the compatibility of national laws. It is also said that a rigorous approach has been adopted in the draft.

Finland can easily accept the limited approach to the scope of harmonisation. The rules in the future Convention should be restricted to those which are clearly necessary in order to ensure legal certainty for cross-border holding and transactions. This is important not only because it may be difficult to reach a technical and political consensus on other matters but mainly because the development of holding systems should not be frozen in any one model. The modern information technology makes it possible already today to process and transfer enormous masses of data online. Thus, long chains of intermediaries are not the only way to handle an increasing volume of cross-border activities.

As you well know, we apply the so called Nordic model, where investors' accounts for dematerialized securities are held with a Central Securities Depository (later the CSD). Our legislation on book-entry accounts has been in force since 1991 and we find that the system is both efficient and reliable (see the attached Annex for a concise description of the system).

We are now concerned whether the Convention will allow us to maintain the Nordic model. There is no doubt that this model fulfils the objectives set for the future Convention, namely the certainty and efficiency of cross-border holdings and transactions. In the present draft Convention the CSD is considered just one of the intermediaries even though the difference between the Nordic model and the model based on pools and a multi-tiered holding is significant. As a more centralized system the Nordic model makes it technically possible to control and trace every transfer in the accounts and thereby to prevent multiplied securities or otherwise uneven or illogical credits and debits in the accounts. The rules on requirements and legal effects of book entries in our system naturally differ from those of the draft.

Investors are much more secured in the Nordic model than in the draft Convention. The CSD and its book-keepers (account operators and their agents) have strict liability on losses caused by an incorrect booking, including also situations where securities cannot be reversed to the rightful owner because of the protection given to a *bona fide* acquisition. There is no need nor room for rules concerning an intermediary's insolvency or other incompetence to provide the account holders with their securities.

These were only examples to describe the legal concept we find worth retaining in the future Convention. It is of high importance that the special features of the Nordic holding systems are taken into account in the coming consultations. And as stated above, the Nordic model doesn't jeopardize the goals of the Convention, quite the contrary. Since there is no chain of intermediaries there are neither problems concerning cross-border transactions nor question about the compatibility of various laws. During the coming negotiations we are, of course, glad to provide you with further information of our system.

Yours sincerely

Tiina Astola
Director of Legislation

Annex**DESCRIPTION OF THE FINNISH BOOK ENTRY SYSTEM****Centralised book entry register**

The Finnish book entry system consists of book entry accounts and lists of the owners of the book entries registered in the accounts. The Central Securities Depository (hereinafter referred to as the “CSD”) is a limited company licensed by the Ministry of Finance. The main duties of the CSD are to maintain the central data system necessary for the operation of the book entry system, to maintain the book entry register and to keep the lists of the book entry accounts. The Ministry of Finance approves the rules of the CSD after a mandatory consultation process with the Bank of Finland and the Finnish Financial Supervision Authority. Only the Finnish Central Securities Depository Ltd. has been licensed to act as a CSD. The operation of the CSD is governed by the *Act on Book Entry System*, the *Act on Book Entry Accounts*, the *Limited Liability Companies Act*, the *Securities Markets Act* and the *Act on Certain Conditions of Securities and Currency Trading as well as Settlement Systems*.

The *book entry register* refers to a register kept by the CSD. The information in the book entry accounts, the book-entries registered in the book entry accounts and the rights and obligations pertaining to the book-entries as well as the holders of rights is maintained in this register. Licensed *account operators* have the right to make registrations in the book entry register. Also *agents* who have concluded a contract with an account operator have the right to make registrations in the book entry register on behalf of the account operator.

According to the Act on Book Entry System the CSD has to monitor that the number of securities registered in the book entry accounts corresponds to the number of securities in circulation. Thus a security may be registered at any one time only in one account and, on the other hand, shall be registered in some account. A constant control over the balance of the accounts prevents in advance legal uncertainties due to possible errors (intentional or not) in registration, etc. The monitoring also guarantees that an account operator is always in the position to fulfil the rights registered in his sub-accounting system. The principle of *delivery versus payment* is reliably confirmed in the simultaneous registrations into the accounts of the seller and the buyer.

Direct ownership of book entry securities

As a main rule, the book entry securities are registered in *investor-specific accounts* kept in the investors' name at the level of the CSD, as opposed to fungible pools. These accounts can include a variety of securities. An investor is considered to have a direct and traceable ownership right to an individual security registered in his account. The right of the investor is neither regarded as a proportional co-ownership right to a pool of securities nor as a special interest in such.

Finnish investors are required to have accounts registered in their own name. In legal terms, the account operators of the CSD don't run their own sub-accounting systems. Instead they operate client accounts in the book entry system acting on behalf of their investor clients. Neither the CSD nor the other account operators are considered to have any proprietary rights relating to securities credited in an investor's account.

Custodial nominee accounts

In addition to the investor-specific accounts the system allows for separate *custodial nominee accounts* for intermediaries who keep book entry securities owned by one or more foreign (non-Finnish) investors. Such accounts contain information only on the custodial account holder instead of the beneficial owner. The division of rights among the beneficial owners is derived from the sub-accounting system of the custodial account operator. No restrictions on disposal or e.g. pledges can be registered in these accounts.

Registrations and publicity

The *legal effects of the accounts* incorporated in the book entry system and of *entries* made in these accounts are governed by the Act on Book Entry Accounts. The actual registration decision is made by entering the decision in the book entry account in question. In the registration procedure it is presumed that the account operator examines the legal grounds and the validity of the registration in question. Competence to apply for registration lies with the account holder. In addition to the account holder, also a pledge holder may apply for registration, in accordance with a written consent of the account holder.

The general public has the right to rely on the validity of the registrations. Thus, persons acting *in bona fide* are protected. An acquisition registered in a book entry account as well as a right pertaining to a book entry and registered in the account have priority over an acquisition and right not registered in the account. If mutually conflicting interests pertain to the same book entry, the right first registered in the book entry account has priority over a right registered later.

The legal effects of the registrations extend also to the issuers. An issuer's performance based on a book entry, e.g. payment of dividend to an account holder, is considered valid. Correspondingly only an account holder may take part in a shareholders' meeting.

Through the book entry system it is also possible to supervise insider trading in real time as well as conduct effective supervision against money laundering and terrorism financing.

Strict liability

Strict liability of the account operator in relation to registrations strengthens the reliability of the book entry system. The account operator is liable to compensate damage caused by an incorrect registration irrespective of whether it is due to e.g. his negligence, fraudulent act by the account holder or a third party or even a technical fault in the system.

A Registration Fund has been established in order to guarantee the fulfilment of the account holders' liability in damages. The account operators are to pay contributions to the Fund and this increases their interest in maintaining the correctness of the operations. The Registration Fund is to compensate an injured party if an account operator has not paid an evident and undisputed claim payable by it according to the Act on Book Entry Accounts. The compensation on the basis on an incorrect registration by an account operator in relation to one investor is limited to 25 000 euros and to several investors to 10 million euros.

In conclusion

The reliability of the Finnish book entry system has its basis in the following main elements:

- Firstly, there is only one central registry operated by the CSD, which leads to a complete control of the balance of the accounts.
- Secondly, an account operator shall examine the legal grounds of a registration and shall be strictly liable for any incorrect registration.

Thirdly, the system is based on transparency.

Mr Francisco Garcimartín Alférez for the Spanish Delegation, 8 April 2005

SPANISH PRELIMINARY COMMENTS ON THE UNIDROIT CONVENTION

1. In the first place, we would like to congratulate UNIDROIT for its efforts in trying to establish common rules dealing with the problems arising from indirect holding systems. Taking into account the level of globalization reached by capital markets, an international Convention on harmonised rules could offer a sound legal system preventing the material risks associated with securities held through indirect holding systems. We also consider that the functional approach adopted by the text is an adequate starting point, and therefore it should be respected throughout the whole text. Thus, the use of terms that may have a certain legal meaning in a given jurisdiction, but may be totally unknown in other (i.e. "nominee") should be avoided.

2. The following commentary does not go through the details of each article of the Draft. This may be premature. In our opinion, it is necessary to address some general issues that could affect the scope of the project. Therefore, we will only comment on those matters which we have considered worthwhile pointing out at this stage of the process.

We would like to focus our memorandum on four general points.

3. **First.** As a Member State of the EU, we would like to stress the importance of coordinating this initiative with the projects launched by the European institutions; in particular, the Legal Certainty Project. It is essential for both projects to be consistent. Although the peculiarities and scope of work of each of them shall be taken into account, the harmonization at a regional level (EU) and the harmonization at a global level should not follow divergent paths. We therefore encourage, to the extent possible, maintaining a fluid coordination of the technical aspects of this project, on a permanent basis, with the work of the Legal Certainty Project. This would enrich both projects. Moreover, to the extent that many of the issues dealt with in this Convention are competence of the Community, we will have to coordinate our position with the rest of the Member States and to follow the –future- mandate issued by the Community. Therefore, all our comments and positions have to be considered under this caveat.

4. **Second.** The Convention tries to offer a sound legal framework for systems of securities indirectly held with intermediaries. In principle, we endorse this objective. There are a number of questions and concerns that have to be discussed; however, we find the basic policy decision underpinning the main articles of the text adequate.

In this context, our main concern is that this text seems to ignore the existence of legal systems where a direct relationship between the issuer and the holder of the securities exists, even in the case of dematerialised securities. The rules and procedures of these systems make it possible for the account holder to be the legal owner of the securities and, therefore, to have a direct and binding title *vis à vis* the issuer. The intermediaries' role is confined to providing evidence of the holder's title. This is the case not only in Spain, but in many other countries in Europe.

Under Spanish Law, when an issuer decides that its securities are to be held through the Spanish system, all securities comprising the issue are held in the books of the CSD and of its participants (the CSD holds for each participant two accounts: an account for securities owned by the participant, and a "clients" account reflecting the exact amount of securities held by the

participant, in its own books, in favour of its clients). *This is conceived as a single registry with two steps* (or a double-tiered single registry system), where the CSD, and by delegation, its participants, hold 100 per cent of the issue. Spanish law is based on this fundamental principle.

Under this legal framework, *securities (i) registered in the Spanish CSD and (ii) held by its participants, are not part of an indirect holding system*. Only when those securities “leave Spain” (that is, are held abroad by another intermediary, in its own books, in favour of third parties) could they be subject to different risks that may be regulated in a different manner.

At this preliminary stage, we would like to stress that for Spain it is of the utmost importance that the project does not interfere with the legal regime on which the Spanish “double-tiered single registry system” is based. We believe that the text of the Convention, as it stands now, fails to recognise this reality, in so far as the protection afforded to indirectly held securities is generalised.

5. **Third.** We would like to express our serious doubts as to whether it is pertinent to include a chapter in this Convention about relations with the issuer of securities. The problems dealt with in Chapter VI are of a completely different nature to those regulated in the rest of the text. The content of this chapter goes to the root of the rules of national corporate law, and its implementation may call for deep reforms on certain features of such national law. These issues should be excluded from the text of the Convention. The project should be limited to the right of account holder *vis à vis* intermediaries and third parties, and to the disposition of these rights.

6. **Fourth.** The Convention tries to offer a high level of protection to the functioning of CSDs (Art. 7, 12, or 16.1.a). This is essential for the stability of those systems and of capital markets generally. Nevertheless, the current draft does not require any kind of control, supervision or recognition by public authorities of systems such as CSD. In principle, we consider that such a requirement should be added to the text. If a CSD is to be protected by certain rules (which do not apply to the rest) some kind of “State supervision” or recognition is called for. The same could be argued in relation to intermediaries that, for instance, will have the privileges laid down in articles 19-22.

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31 March 2005

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For the attention of Dr Philipp Paech
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Dear Sirs,

Preliminary Draft Convention on Harmonised Substantive Rules Regarding Securities Held with an Intermediary (Study LXXVIII – Doc. 18)

Thank you for your letter of 31 January 2005 informing us of the first session of the UNIDROIT Committee of governmental experts for the preparation of the preliminary draft Convention referred to above (the **Draft Convention**) from 9 to 20 May 2005 and inviting us to designate one or more observers to represent the International Swaps and Derivatives Association, Inc. (**ISDA**). We are pleased to accept your kind invitation and will be in contact separately with regard to the names of our observers and other administrative arrangements in connection with the May session.

As you know, we have been following this initiative with great interest, having commented in our letter of 6 September 2002 on the proposed scope of the project, in our letter of 11 November 2003 on your Position Paper of August 2003 on Harmonised Substantive Rules Regarding Indirectly Held Securities and in our letter of 3 September 2004 on the preliminary draft Convention published by UNIDROIT in April 2004.

ISDA is the global trade association representing participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions. Promoting legal certainty for cross-border financial transactions through law reform

is one of ISDA's core missions. ISDA was chartered in 1985 and today numbers over 600 member institutions from 47 countries on six continents.¹

ISDA continues strongly to endorse this initiative. This is important work. We believe that the reasons why this is so are well set out in Part 2 of the Explanatory Notes (Study LXXVIII – Doc.19) (the **Explanatory Notes**).

Clearly, law reform on this scale takes time and requires careful consideration. We note that the UNIDROIT Governing Council decided to commence work on this project in September 2001. Given the size and importance of the international securities markets, it is important that this project now moves forward as quickly as possible to the conclusion of an international instrument on these issues.

We not only endorse this initiative, but we also endorse the functional approach described in Part 3 of the Explanatory Notes, the use of neutral language and the importance of ensuring that the instrument is acceptable to, and can be effectively implemented in, jurisdictions of all of the world's major legal traditions. The Explanatory Notes caution that there are limits to the functional approach, and we agree that a careful balance needs to be struck to ensure that the goals of legal certainty and international compatibility are achieved.

In this regard, there are references in some articles of the Draft Convention to the relevant applicable law (as defined in Article 1(3)). We believe that the intended interaction between the rules in the Draft Convention and the applicable law is not always as clear as it could be, and we would urge that these references should be given careful attention at the governmental experts session in May of this year.

We are pleased to note that points we raised concerning the prior preliminary draft Convention are now included or reflected more clearly in the Draft Convention. The Explanatory Notes on the detail of each Article of the Draft Convention are particularly helpful. We do have some continuing concerns, which are noted below.

We continue to underline strongly the importance, in particular, of ensuring that the particular characteristics of securities intermediation do not frustrate the reasonable expectations of market participants, for example, in relation to issues such as an account holder's right to receive interest or dividends or other distributions, to exercise voting or other corporate rights or to exercise a right of set-off against an issuer of securities to the extent that it would have had such a right under the direct holding system. We note that these issues are dealt with in Articles 2(1), (3) and 18. Article 18 is of particular importance from the point of view of the financial markets.

A consistent theme in our prior comment letters to UNIDROIT regarding this project has been the importance of recognising and giving proper effect to title transfer collateral arrangements. In the privately negotiated derivatives market, a significant proportion of financial collateral arrangements are based on the title transfer approach, rather than on the creation of a security

¹ For further information on ISDA and its activities, please consult our website at <http://www.isda.org>.

interest in financial collateral. In some parts of the world, for example, in Europe, it is the predominant approach used for cross-border collateralised derivatives trading.²

We note that the Draft Convention recognises the existence of title transfer collateral arrangements, for example, in the definition of “disposition” in Article 1(h),³ and any of the provisions relating to transfers of securities will therefore clearly be relevant to such arrangements. Article 3 is especially helpful in this regard, in particular, of course, Article 3(6).

We believe, however, that Chapter VII, which includes the special provisions with respect to collateral transactions, should be expanded to cover title transfer collateral arrangements. Articles 20 and 21 would continue to be relevant only to security interest collateral arrangements, but Article 22 should apply to both security interest and title transfer collateral arrangements. Also, an additional Article should be added to this Chapter to deal specifically with the issue of recharacterisation risk in relation to title transfer collateral arrangements and to strengthen local law relating to netting and/or insolvency set-off as necessary to ensure the effectiveness of title transfer collateral arrangements.

We note that this “twin track” approach of protecting both security interest and title transfer collateral arrangements is reflected in both the European Financial Collateral Directive⁴ and also the Hague Securities Convention⁵.

We think that it is regrettable that it is necessary to include an opt-out from Chapter VII, but we understand the reasons for this, as set out in the Explanatory Notes.

As we have previously noted in our letter of 3 September 2004, we would favour extending the scope of the Draft Convention to include natural persons. We note the discussion of this point in the Explanatory Notes, and in particular the suggestion, with which we agree, that it is not clear that a natural person as collateral provider would be less protected under this regime. In fact, a natural person would benefit, as would any market participant, from the greater certainty and other benefits of the proposed regime.

We are not proposing to offer a comprehensive commentary on drafting issues in this letter, but we thought it might be helpful to offer the following few points:

1. It would be helpful to clarify the position of, say, a trustee or a comparable fiduciary as account holder in relation to Article 2(1). Sub-paragraph (a) deals with the position of the “ultimate” holder, but the Article appears to be silent on the rights of a trustee or a comparable fiduciary to receive the benefits of or exercise the rights associated with the securities for its beneficiaries.

² For statistical information on the various types of financial collateral arrangement used in the cross-border privately negotiated derivatives market, see ISDA’s annual Margin Surveys. These may be consulted on the ISDA website at <http://www.isda.org>.

³ For this reason, we would favour retaining this definition (that is, removing the square brackets) and adding a definition of “acquisition”, as suggested in the Explanatory Notes.

⁴ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

⁵ The Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, the text of which was adopted by the Hague Conference on Private International Law in December 2002 (but which is not yet in force).

2. It might be helpful in a future draft of the Explanatory Notes to explain more clearly how the perfection of security interests is dealt with in the Draft Convention, which appears to be a combination of provisions in Articles 3 and 4 and possibly elsewhere. The necessary elements appear to be there, but it would be helpful to have a description of how it all “hangs together”, especially given the importance of the concept of “control” of book-entry securities to the issue of perfection in, for example, the European Financial Collateral Directive and in Articles 8 and 9 of the US Uniform Commercial Code (and in similar personal property security statutes of other jurisdictions such as New Zealand and the Canadian provinces).
3. In Article 18(1), perhaps it should be clarified that this provision only applies where the account holder is “acting for its own account with respect to the securities” (which tracks language used in Article 2(1)(a)).
4. In Article 20(2) is it necessary to qualify the secured obligations as being obligations “of a financial character”? Presumably any debt, whether arising out of a financial transaction, a commercial transaction or otherwise, should be eligible to be collateralised by an arrangement benefiting from these provisions.
5. As a general principle, we would like to see definitions in the Draft Convention that also appear in the Hague Securities Convention conformed as far as possible. The Hague Securities Convention deals with a fundamental threshold issue, namely, which law is applicable, and may be viewed as a foundation stone of the legal certainty project for intermediated securities. To that extent, the Draft Convention should build on the work reflected in the Hague Securities Convention and any legal certainty issues arising from inconsistencies between the two documents should be eliminated as far as possible.

We wish to commend the Study Group for the hard work it has done, for the high quality of the Draft Convention and the Explanatory Notes. We would be pleased to continue to support this project in any way that we reasonably can, for example, by providing further information or assistance regarding international financial market practice. ISDA and its members will continue to follow the development of this project with great interest. If you have any questions regarding our comments or desire any further information, please feel free to contact the undersigned.

Yours faithfully,

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European Banking Federation
Enclosure to the letter dated 18 April 2005

**FBE OBSERVATIONS ON UNIDROIT PRELIMINARY DRAFT CONVENTION ON
HARMONISED SUBSTANTIVE RULES REGARDING SECURITIES HELD WITH AN
INTERMEDIARY**

Established in 1960, the European Banking Federation ('FBE') is the voice of the European banking sector, representing the interests of over 4,500 European banks from 26 national Banking Associations, with over 2.3 million employees and total assets of more than 20,000 billion euros.

A. Introduction

FBE is honoured to have been invited by UNIDROIT to formulate comments on the preliminary draft Convention on Harmonised Substantive Rules regarding Securities held with an Intermediary (hereinafter, 'the Draft Convention'), released by the UNIDROIT Study Group in December 2004.

FBE considers the Draft Convention a very important contribution to the ongoing work aiming at achieving an efficient, competitive market for cross-border securities transactions at a global level.

FBE particularly welcomes the initiative of UNIDROIT at the international level as timely undertaken considering the work of the European Commission in the same field. In this regard, FBE would strongly recommend that both initiatives come along a consistent approach and contribute to the creation of a coherent framework at the international as well as at European level.

Market practices in some cases diverge from national legal systems, in particular regarding the application of rules - shaped upon physical goods (paper instruments or certificates) circulating via actual transfer from one person to another - to assets that are no longer mobile (since their immobilisation within a Central Securities Depository) nor of a tangible nature (they exist in the form of computer records).

While acknowledging the relevant changes occurred in recent years in market practices regarding the holding and transfer of securities, FBE sees the Draft Convention as an opportunity to ensure legal certainty on transactions vis-à-vis the various parties involved within the indirect, multi-tiered holding systems currently operating in major markets and based on circulation of securities mainly by book-entry.

On this general premise, some remarks and amendments to the draft are proposed below.

B. Specific Comments

1. Scope of the Draft Convention

The Explanatory Notes to the Draft Convention define the scope of the latter as established according to a criterion of need: ***“a harmonised rule should be regarded as necessary if it is clearly required for the reduction of legal or systemic risk or for the promotion of market efficiency”***. Since it is acknowledged that a full harmonisation may appear a difficult aim to achieve, both from a technical and a political point of view, such a restrictive approach to the scope of the Draft Convention is thus suggested within the Explanatory Notes⁶.

While agreeing that the level of harmonisation to be retained should not go beyond what is achievable and really needed, FBE remarks that no definition of the scope of application is at present inserted in the Draft Convention. Whereas from the joint reading of the title and the Definitions Chapter we assume that the latter applies only to securities held with an intermediary, a clarification in this sense would be helpful. We would also recommend this in order to refer to a clear framework when addressing the different “layers” of the “chain”⁷.

It is also specified within the Explanatory Notes⁸ that the cross-border nature of transactions could not prove to be an efficient criterion to define the scope of application of the Draft Convention, as it would imply an excessively difficult exercise of classifying any transaction as having a cross-border element or not. The practical solution retained is thus that the Draft Convention would apply to both domestic and cross-border transactions.

We must note in this regard that, from an EU perspective, the Draft Convention as well as The Hague Convention aim at regulating a matter falling under the shared competences of the European Community and the Member States. The EU Council of Ministers will have to define, in the mandate for negotiation provided to the EU Commission, the extent to which such negotiation may be undertaken⁹. The scope of application of the future Convention within EU Member States’ legal systems will thus depend on the document that is finally adopted by the EU Council.

2. Definitions

FBE would first emphasise the need to ensure consistency of definitions among all the different (international, European, national) levels of legislation.

⁶ See p. 18 of the Explanatory Notes.

⁷ See p. 6 of the Explanatory Notes. It should also be noted what stated within the Explanatory Notes in page 5, footnote 42 regarding the different meaning of “direct/indirect holding system”. UNIDROIT should carefully address the issue of compatibility of definitions inserted in the Draft Convention with national legal systems (e.g. Spain) that refer to one or another of the two systems illustrated in footnote 42 of the Explanatory Notes.

⁸ See p. 20 of the Explanatory Notes.

⁹ More precisely, according to Article 133 of the EC Treaty, the Council and the EU Commission shall be responsible for ensuring that the Convention to be negotiated is compatible with internal EC policies and rules. Indeed, the right of the EU Member States to maintain and conclude agreements with third countries or international organisations is not affected by the EC Treaty **insofar as such agreements comply with Community law** and other relevant international agreements.

Although assuming that the Convention applies only to securities held with intermediaries, a few additional definitions would be helpful in order to clearly refer to the different “layers” of the “chain”, in particular a definition of what is meant by:

- “clearing and settlement systems”;
- the “*issuer*”, who plays a vital role in the “chain” and must have direct contact with the investor/shareholder owning the securities, particularly in a dematerialised environment.

When defining the rights resulting from securities credited to an account, the direct link between holder and issuer of such securities would need to be addressed or at least defined. It would be desirable to recall in Article 2.2 the existence of the direct rights governing the relationship between the holder of the securities and their issuer (i.e. voting rights, dividend rights), according to the issuer's local law. However, this should not detract from the most important aspect of shareholders' and issuers' rights, namely their mutual relationship (see Article 17). It should therefore be stated in Article 2.2 that the relationship between the holder and the intermediary merely complements the fundamental relationship between holder and issuer, particularly in the process whereby the integrity of the issuer's account with the central operator is ensured via a chain of intermediaries.

Article 1

With regard to specific definitions, FBE acknowledges the reference made by the Draft Convention to the definitions already laid down by The Hague Convention and welcomes the approach led by consistency. However, some clarification might be brought, in particular on the definition of securities: the scope of the intermediated securities covered by the Draft Convention should be clarified to ensure that it encompasses not only bearer securities but also registered securities¹⁰

We would further note that a more coherent approach to definitions of “disposition” throughout both the Draft Convention and the Explanatory Notes would be advisable; indeed when speaking about disposition in the latter, it is used¹¹ coupled with “acquisition” and in an interchangeable way with “debit” and “credit”, while the definition in Article 1 h) tends to include both the kind of transactions by defining as “transfer of title”. We would recommend to clarify this point, possibly also by adding a definition of “acquisition”.

Article 2

The 1st sentence of paragraph 1 may be completed, after the words “*confers on the account holder the following rights*”, with the words “*including when directly enforceable against the issuer*”¹², in order to explicitly acknowledge the existence of such direct rights.

¹⁰ It would also be useful to clarify whether, given the definitions of “securities account” and “intermediary”, securities recorded in ‘pure’ registered form with the issuer are covered by the Convention and, as a consequence, whether the issuer who holds securities in registered form in the name of and for the account of the holder should be considered or not as an intermediary. This matter is of particular importance for those countries where issuers may provide shareholders with an in-house securities account for specific kind of registered securities (e.g. in France the so called *titres nominatifs purs*).

¹¹ See p. 20 and s.

¹² Alternatively, Article 2.1 e) could be supplemented at the end by the sentence “*also when/if enforceable directly against the issuer*”.

Both Article 13 and Article 2.2 b) are designed to prevent the rights of the investor being enforced at a level higher than that of the relevant intermediary. The authors of the Draft Convention pose the question of whether Article 13, which contains an obligation to this effect for the intermediary, is sufficient or whether Article 2.2 b) is also necessary. We believe that Article 2.2 b) is particularly necessary to make clear that the investor himself can enforce his rights against the issuer.

More generally, while, according to the Draft Convention, the content of the duties of the intermediary to enforce the investor's rights against the issuer or against higher-ranking intermediaries is to be based on the safe-custody agreement, the possibility to also set a framework for the duties of intermediaries on a statutory basis or in some other way, e.g. under supervisory law, should not be ruled out. In this regard, FBE favours the addition of the last part "*and the applicable law*" in Article 2.3 b).

We draw your attention on the fact that in order to eliminate the discrepancy that is between the English and the French versions of Article 2.3 a) the word "relevant" should be added to the latter so as for the two linguistic versions to be in line with each other.

Article 3

Article 3.3 refers to the effectiveness of acquisition against third parties. It is not clear whether the reference to third parties in the present Draft Convention means that the effectiveness against the intermediary is not to be covered. Nonetheless, the Explanatory Notes¹³ say: "*Most jurisdictions give an account holder's right the status of being generally effective against anybody, i.e. the intermediary and third parties. This is also one of the foremost objectives of the preliminary draft convention.*" We then suggest that Article 3.3 should simply regulate the effectiveness of acquisition, and not only the effectiveness against third parties or, alternatively specify that the intermediary is considered as a third party (e.g. "*including the intermediary*").

Article 3.3 stipulates that, besides the crediting of securities to a securities account, no further step or event is necessary to make acquisition or disposition of securities held with an intermediary effective against third parties. This is, however, in contradiction with Article 5.1 which states that a debit or credit of securities to a securities account is not effective against third parties unless it is made with the authority of the account holder. Furthermore, under Article 5.2, a debit or credit of securities to a securities account may be made conditionally.

It would be desirable here to make clear that the effectiveness of acquisition/disposition of the securities by the account holder does not – whereas this would be the case - depend only on their crediting/debiting to a securities account but also on further conditions. In addition, the categorical provision of Article 3.3 is qualified by Article 7, which states that certain rules of clearing and settlement systems have overriding effect.

In the Explanatory Notes¹⁴ we do not understand the following: "*Securities held with an intermediary is a defined term and refers to the right specified in Article 2. Thus, an acquisition or disposition of securities, as defined in Paragraphs (1) and (2) respectively, does not mean that the account holder acquires or loses the right to the benefits of the investment, as set out in Article 2 (1)(a).*" Does this mean that someone can lose credited securities but still remains the

¹³ See p. 26, Article 2 (2).

¹⁴ See p. 27, Article 3.1-4.

holder of the rights (to dividends) associated with such credited securities? A clarification in the Explanatory Notes seems necessary.

Finally, Article 3.4 as drafted appears quite unclear; we suggest instead to replace it with a sentence closer to what is written in the (more straight) Explanatory Notes so that the section reads as follows: "*The credit or debit [of securities] does not depend on whether a corresponding debit or credit can be identified as taking place anywhere [in the chain]*".

Article 4

Under Article 4.1 b), a security interest over securities held with an intermediary is created in favour of a person other than the relevant intermediary, by designation of specific securities/securities account over which this person may impose requirements that the relevant intermediary must comply with. The Draft Convention also stipulates (Article 9.1 a) that a security interest created in this way has priority over security interests that are created by any other method different from what provided for by the Draft Convention and permitted by applicable national law.

The condition that the person taking the security (or security taker) may impose over the relevant intermediary any "binding" requirements related to the securities/securities account – thus including the free disposition of them -, could prove to be too far reaching without taking sufficient account of the need for the security provider to be protected against improper disposition by the security taker. The aim of protecting the interests of the security taker might be satisfactorily achieved without making such a right of "free disposition" a condition for the creation of the security interest itself. In this sense, the protection offered by the type of security interest like the pledge should at least remain available. We would also recommend to carefully evaluate the consequences of such a right of disposition in relation to voting rights and dividend rights pertaining to the securities taken as security interest.

Article 4.2 provides that the security interest is not *effective against third parties unless* (...) the securities account is so *annotated* as to indicate its existence. FBE invites UNIDROIT to clarify what is meant by "annotation" and thus carefully verify whether there is any potential conflict between such a provision and the relevant Article 3.1 of the EU Directive 2002/47 on Financial Collateral that prevents Member States from requiring the performance of any formal act in order for a financial collateral agreement to be created, valid, perfected, enforceable or admissible in evidence. In our view, if the annotation referred to in Article 4.2 is to be understood as identification (e.g. earmarking) in the intermediary's books, there should be no conflict; on the contrary, any further publicity requirement, such as registration in a public register or the like, could represent an infringement of EU Directive's provisions.

Further, Article 4.2 relates to the effectiveness of the creation of a security interest against third parties. We believe that it must relate to the effectiveness against anyone. It is not clear what the legal consequences would be if a security interest created in favour of a third party was not effective against this party due to non-publicity, but was effective against the intermediary. The words "*against third parties*" in Article 4.2 should be deleted or alternatively it should be specified that the intermediary is considered a third party (e.g. "*including the intermediary*").

Articles 5 and 6

From a general perspective, according to the headings to the above-mentioned articles, Article 5 deals with the *effectiveness* and Article 6 with the *finality* of debits and credits. However, both

articles then only refer to the *effectiveness*, which raises the question of how the terms *effectiveness* and *finality* are to be separated in a legal sense.

In addition, when comparing the two linguistic versions, a mismatch appears between the French text and the English one as regards the highlight of Article 6: according to the provision of that Article, the word "*Irrévocabilité*" should be translated into "Irrevocability" while "Finality" has been chosen. In our opinion, however, a proper definition of what "finality" is, is still missing in the Draft Convention.

This raises the question in particular of whether *finality* is supposed to mean the settlement of transactions. It needs to be clarified how these terms stand in relation to the concept of finality described in the EU Directive 98/26 on Settlement Finality, which interprets finality merely as irrevocability¹⁵ and enforceability¹⁶, but not as legal settlement, however.

By using the term *finality* indiscriminately for all financial market participants (especially intermediaries), Article 6 is likely to undermine the security that marketplace systems derive from European integration. Indeed the prudential chain which guarantees that securities are actually held by the relevant intermediary hinges on the concept of "central finality".

As regards irrevocability, this term should not be addressed in this Convention since it only relates to securities settlement systems. Finality is aimed at protecting participants from any systemic risks triggered by the unpredictable cancellation of a book entry. The Draft Convention should only deal with the protection of acquirers acting in good faith.

Additionally, we also remark that Article 5.4 and Article 5.5 are difficult to understand and should therefore be worded more clearly to avoid any misunderstandings.

Finally, the words "*against third parties*" should be deleted in paragraphs 1 and 2 of Article 5. These provisions should also cover the effectiveness of debits and credits in the relationship between the account holder and the intermediary.

Appropriate amendment of Articles 5 and 6 would be desirable.

Article 7

Article 7 gives priority to any provisions of the rules or agreements governing the operation of clearing or settlement systems which are directed to the stability of the system or the finality of dispositions effected through the system. Only giving these provisions priority over Articles 5 and 6 is unlikely to be enough, as Article 3 in particular shows. We especially welcome that Article 7 gives priority not only to rules and regulations but also to contractual agreements between the system and system participants. We thus recommend the second option left in the Draft Convention so that Article 7 reads as follows: "*Any provision of the rules or agreements governing the operation of a securities clearing or settlement system which is directed to the stability of the system or the finality of dispositions effected through the system shall, to the extent of any inconsistency, prevail over any provision of this Convention*".

¹⁵ See Article 3 of Directive 98/26.

¹⁶ See Article 5 of Directive 98/26.

However, the Convention should specify which rules and regulations are concerned. The present wording appears too general. Taking the definitions and proposals of CPSS/IOSCO, CESR/ECB and others as a basis, the content of the rules and regulations could be described in more detail or examples given. Such an approach would, on one hand, give the clearing and settlement systems the flexibility they need to operate securely and efficiently and, on the other hand, promote both harmonisation and transparency.

To avoid any misunderstandings in practice, the Draft Convention should also define what is meant by "*clearing and settlement systems*". For this purpose, it would be advisable to include a definition in Article 1 as mentioned above.

Article 8

UNIDROIT should better distinguish between (i) rights enforceable by holders for own account and (ii) rights enforceable by holders for third parties in order to prevent any attachment of account held for third parties at the "omnibus" level. The current definition of "relevant intermediary" does not indeed prevent upper tier attachment since any intermediary, and especially those holding an account on behalf of third parties, qualifies as a relevant intermediary. In this view, UNIDROIT should ensure that the relevant definitions are made efficient and consistent with this purpose throughout the whole Draft Convention.

Article 9

Article 9 is a key article and is referred to by Articles 3.7 and 4.5. We agree with Section 9.3 which provides that the priority of competing interests in securities held with an intermediary is determined by the applicable law. However, we notice that such provision is immediately restrained by Section 9.4, according to which the priorities of Section 9.3 may be varied by agreement between the persons having competing interests. The Explanatory Notes¹⁷ make clear that this is only possible where the interests of third parties are not affected.

The Draft Convention does not contain such a clarification, although this would be needed. In the absence of such clarification, and considering the legal uncertainty of the parties' agreement regarding third parties' rights and systemic risks, we would rather recommend that Section 9.4 be deleted.

Article 10

The notion of "***bona fide acquirer without notice***" is commonly used under UK and US law, which is not the case of the "innocent person". This notion is a lot closer to the French notion of "***tiers acquéreur de bonne foi***" and we fail to understand why it is not referred to in the English version of the Convention¹⁸.

¹⁷ See p. 30.

¹⁸ In the case of dematerialised securities, the need for legal certainty requires the implementation of a common rule in order to protect the *bona fide* acquirer. In order to acknowledge to the transferee a clear and valid title, the protection could be granted to any transferee if the latter were not aware of any challenging action at the time he received the securities in his account. In this respect, the acquirer should be in a position to clearly ascertain whether the conditions upon which he receives the securities are, in his knowledge, clear or challengeable.

Furthermore, good faith acquisition should not be ruled out if the creation of a security interest is effected by way of gift or otherwise gratuitously. In our view, there is no reason not to protect a good faith acquirer if the security interest is created gratuitously.

Finally, we understand Article 10.3, final sentence, which refers to the imputation of knowledge, to mean that good faith acquisition is ruled out if the information has been received by the "organisation" and is not duly forwarded within the "organisation". This interpretation should be reflected in either the Convention itself or at least in the Explanatory Notes.

Article 13

In order to strengthen the provisions set forth in Article 7 and match the reality of the market, whereby the operator of a clearing or a settlement system may impose on an intermediary to liquidate its position (and get rid of inconsistencies), it seems necessary to add the following exemption, under a Section 13.2 (e) providing that Article 13.1 is subject also to "*the rights of the operator of a clearing or settlement system as regards to the agreements with its participants*".

In addition, we suggest that the duties of the intermediary should be complemented by including a liability rule stipulating that liability on the part of the intermediary for any wilful or grossly negligent breach of duty may not be precluded.

Article 14

It should be noted that provisions relating to the allocation of costs seem inappropriate and irrelevant in the Draft Convention (sections 4 and 5 of Article 14).

Article 14 should also include a rule whereby "client" accounting is segregated from "proprietary" accounting. This would prevent any of the intermediary's creditors from taking possession of the client's securities held by the intermediary. If a mismatch is noted between the securities registered in the client's name on the intermediary's accounts and the rights to which that client is entitled (especially where the intermediary is financially distressed or bankrupt), it should be possible to precisely limit that mismatch then immediately compensate it, notably through buy-ins or borrowing in the market. Only in the very last resort the client's rights should be reduced. Therefore, because the distinction between proprietary and client accounting must be made in Article 14, this article should also set out the handful of very specific cases in which the client's rights would be reduced.

Article 14.6 should not provide that in case of discrepancy, the account holder shall not be impacted by it; particularly with voting rights, such account holder cannot be in a position to vote if its intermediary does not hold the relevant securities with a CSD, the issuer or another intermediary. In this particular situation, there is de facto a creation of securities, unless any lending securities program has been implemented. This is contrary to the legal certainty in the market and should be clearly limited to a restricted exception to Article 14.1.

Article 16

Article 16 stipulates that, in the event of a shortfall in the securities held in respect of account holders' rights or the insolvency of the intermediary, liability is shared among all account holders on a pro-rata basis.

The provisions refer to regular market practices, where, for instance in Continental jurisdictions, the rule always provides a protection for account holders by granting the latter a direct right, as far as possible, to have their financial instruments transferred with another custodian. If it is not the case, the securities are proportionally apportioned among the relevant account holders.

However, sharing liability in this way might appear unreasonable when the shortfall is due to the investor receiving an uncovered credit. While it may well be impossible in practice to determine which of the numerous credits received daily has been made without sufficient cover, liability should not be shared on a pro-rata basis in cases where this can be established. It would be fairer in our view to let this investor bear alone the consequences of the lack of cover. For any subsequent loss in collective holdings of securities caused, for example, by *force majeure*, rioting, war and natural disasters, pro-rata liability of all investors “participating” in the cover is in our view a fair approach.

In Article 16.2 b), the words “*are credited or debited*” should be changed to “*were credited or debited*”, as crediting or debiting naturally precedes the distribution of losses.

Article 17

Article 17 prohibits any rules of national law and any provisions of the terms of issue of securities that would prevent the holding of securities with an intermediary or the effective exercise of rights by an account holder in respect of securities held with an intermediary.

As regards national rules of law, the requested amendments should be a matter of the legislator’s intervention and should be practicable. But it is questionable if the same goes for the terms of issue of securities, as this would mean that securities could only be issued in a form suitable for collective custody.

While the provision under Article 17.2 c) would be quite similar to the current legislative framework in countries of common law, it may prove difficult to be implemented since nominees or trustees, or the distinction between legal and beneficial owners, are not always concepts identified in countries of civil law.

Article 17.2 e) stipulates that, in particular, rules of national law that impose restrictions on the holding of securities with an intermediary by referring to the status or other characteristics or circumstances of the intermediary must be removed. It is doubtful whether Article 17.2 e) is thus necessary to harmonise substantive law. This reservation is based on the fact that system stability can, for example, only be ensured if the investor receives not only a legally secure position but also a position that is largely independent from the economic fate of the participating intermediaries.

It is therefore conceivable that national law imposes restrictions on domestic intermediaries with regard to the foreign intermediaries with which they may establish business relations in order to ensure that they only establish business relations with foreign intermediaries whose organisational form and business activity do not suggest any adverse effect on the stability of the system. The Explanatory Notes (p. 11, section 2.2.3) draw attention to a possible domino effect between linked intermediaries if one of them is unable to meet its obligations. Particularly in the case of intermediaries located in countries that will not have joined the UNIDROIT Convention, the content of the law applicable to them should also be of importance for assessing system security – in terms of both internal soundness and compatibility. Against this

background, Article 17.2 e) should be dropped and replaced by adding to paragraph 1 a restriction on business relations with “unsafe” intermediaries.

Articles 18

It would be useful to clarify that Article 18 deals with the use of “set-off” i.e. netting practices (equivalent to “compensation” in French) and not to the English concept of “*compensation*”, which translates as “*dédommagement*” in French.

Articles 19 to 23

While referring to what has been indicated under Chapter 1 (Scope of the Draft Convention) on the compatibility of the future Convention with the Community Law, we note that EU Member States are bound by EU Directive 2002/47 on Financial Collateral and its implementing measures to be adopted at national level. We therefore support the opt-out option left to Member States in Article 23 regarding Chapter VII.

In any event, Article 19 et seq. could only be suitable if their scope is confined to collateral providers who are not natural persons. Such special provisions are advisable only for collateral providers who normally conduct these transactions on a large scale in the financial markets, and these are usually institutional market participants. The wording in square brackets in the second line of Article 20 (1) should therefore be adopted.